In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 466

OIL BASE, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

This case involves the scope of the Commissioner's statutory power under 1954 Code § 482 to reallocate income between entities which are under common control. We have set forth § 482 and the most pertinent portion of the Regulations thereunder in the Appendix.

Petitioner manufactures and sells oil base drilling fluid and related products to the oil drilling industry. Prior to June, 1958, petitioner made its foreign sales through various independent sales representatives. At that time it created a new Venezuelan subsidiary and executed a contract making the subsidiary its exclusive foreign sales representative (except for Can-

231-444—66

ada) at a stated rate of discounts and commissions approximately double those paid to its previous independent sales representatives. Petitioner's Venezuelan subsidiary had one full-time employee and a capital of $6,000. For its fiscal year ended September 30, 1959 (the period here in question), the Venezuelan subsidiary had net earnings of $81,000, while petitioner's net income for the same period was $20,457 (Pet. App. 2–33).

The Commissioner, acting under § 482 of the Internal Revenue Code of 1954, rejected the stated commissions and discounts as not clearly reflecting the income of the parties and as having the effect of improperly shifting income from petitioner to its controlled foreign subsidiary. Pursuant to Treas. Reg. § 1.482–1(b)(1), the Commissioner allocated to petitioner that income which arm's-length arrangements with uncontrolled foreign sales representatives would have produced. The Tax Court and the court of appeals upheld the Commissioner's determination (Pet. App. 2–6).

The decisions of the lower courts, which are primarily factual in nature, are supported by the record and are clearly correct. There is no conflict among the circuits or other reason for further review.

1. The purpose of § 482 is to prevent a taxpayer from arbitrarily shifting part of its income to another related taxable entity by such devices as excessive commissions, discounts, fees, etc. The Commissioner's authority to reallocate income between related corporations extends to any case in which,

either by inadvertence or design, the taxable net income is different than it would have been had the corporations dealt with each other at arm's length. *Commissioner* v. *Chelsea Products,* 197 F. 2d 620 (C.A. 3); *Aiken Drive-In Theatre Corp.* v. *United States,* 281 F. 2d 7 (C.A. 4); *Spicer Theatre, Inc.* v. *Commissioner,* 346 F. 2d 704 (C.A. 6); *Simon J. Murphy Co.* v. *Commissioner,* 231 F. 2d 639 (C.A. 6).

Section 482 vests the Commissioner with broad discretion, and his determinations under that provision should be overturned only if shown to have been arbitrary or unreasonable. *Helvering* v. *Taylor,* 293 U.S. 507; *G.U.R. Co.* v. *Commissioner,* 117 F. 2d 187 (C.A. 7); *Ballentine Motor Co.* v. *Commissioner,* 321 F. 2d 796 (C.A. 4); *Campbell County State Bank, Inc. of Herreid, S.D,* v. *Commissioner,* 311 F. 2d 374 (C.A. 8); *Spicer Theatre, Inc.* v. *Commissioner, supra; National Securities Corp* v. *Commissioner,* 137 F. 2d 600 (C.A. 3), certiorari denied, 320 U.S. 794; *Grenada Industries* v. *Commissioner,* 202 F. 2d 873 (C.A. 5), certiorari denied, 346 U.S. 819. The record in the instant case adequately supports the lower courts' conclusion that the Commissioner did not abuse his discretion or act unreasonably in invoking and applying § 482.

2. Petitioner argues that certain factors bearing on its Venezuelan subsidiary's business activities justified its action in granting the subsidiary commissions and discounts which were double those given its previous independent sales representatives. The lower courts fully considered these factors and re-

jected them as unsupported by the record (Pet. App. 30–31, 6).[1]

3. Petitioner argues that the Ninth Circuit's opinion in *Frank* v. *International Canadian Corp.*, 308 F. 2d 520, has created uncertainty as to the standard to be applied under § 482 in testing transactions between related corporations. As that opinion makes clear, the court's limited departure from the arm's-

[1] For example, although petitioner claims that its former principal sales representative, Baritina, was seeking larger commissions and discounts (Pet. 5), the record shows that shortly before petitioner formed its new subsidiary, Baritina had expressed willingness to continue at the old rate of compensation (I.R. 32–35; Pet. App. 12, 15).[4] (R. references are to the reproduced record filed in the court of appeals.) Moreover, petitioner's president testified that if Baritina sold petitioner's products properly, it could make an adequate profit at the existing rate of commissions and discounts (II–R 48). Finally, the record shows that petitioner's contract with an independent Canadian representative and its Venezuelan subsidiary's contracts with three independent subagents—all made subsequent to petitioner's contract with the subsidiary—specified approximately the same rate of compensation as had been paid under the old Baritina contract, *i.e.*, approximately one-half the amount petitioner paid its Venezuelan subsidiary (Pet. App. 19–20, 2).

Petitioner argues that in two tax years subsequent to the period here in question its Venezuelan subsidiary suffered losses totalling $4,000 (Pet. 9). Petitioner is apparently attempting to use these figures to show that the compensation received by the subsidiary was not excessive. However, since the alleged loss years (1961 and 1962) were not involved in this case (which concerned only 1959), no effort was made at trial to substantiate the figures, and, in fact, petitioner refused to produce its Venezuelan subsidiary's books and records for these years. Nor, assuming that the subsidiary did suffer small losses in 1961 and 1962, was any effort made to ascertain whether they were due to some external factor, such as political turmoil in Venezuela.

length standard was based upon an inartfully worded stipulation which the court "might well [have used to] find that the Commissioner stipulated himself out of court of this issue" (p. 528), and on the failure of the record to support the commissioner's determination on mark-up (p. 529). In any event, in deciding the instant case, the Ninth Circuit—the same court that decided *International Canadian Corp.*—accepted the arm's-length standard contained in the § 482 Regulations and stated that its prior decision in *International Canadian Corp.* was "very narrowly limited" (Pet. App. 5).

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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SEPTEMBER, 1966.

APPENDIX

Internal Revenue Code of 1954:

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

(26 U.S.C. 1964 ed., Sec. 482.)

Treasury Regulations on Income Tax (1954 Code):

SEC. 1.482–1. *Determination of the taxable income of a controlled taxpayer.*

* * * * *

(b) *Scope and purpose.* (1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions

and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If however, this has not been done, and the taxable income are hereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

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Petitioner's Brief in Reply to the Memorandum for the Respondent in Opposition.

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Petitioner's Brief in Reply to the Memorandum for the Respondent in Opposition.

The Respondent in his Memorandum in Opposition in this proceeding states that with respect to the issue involved, there is no conflict among the circuits or other reason for further review. The Petitioner does not contend that a conflict among the Circuits exists. However, the Petitioner does contend that this case presents to the Court an opportunity to put to an end the uncertainty and confusion which exists in the increasingly important areas of tax law administration and international business operations. The Respondent does not answer this contention. Indeed he cannot, since, as pointed out in the Petitioner's Petition, the uncertainty and confusion in this area is well recognized. (Pet. pp. 11-12.)

The Respondent argues that the purpose of Section 482 of the Internal Revenue Code is to prevent the arbitrary shifting of income. Petitioner continues to contend, however, that the Commissioner's power to so allocate income and deductions is not such as to permit him to force one of the controlled corporations to operate at a loss. The exercise of such power to such effect must constitute an arbitrary and unreasonable exercise thereof.

The Respondent contends that the decisions of the Courts below are in part supported by the fact that the Petitioner's wholly-owned foreign subsidiary had during the taxable year in question only one full time employee and that the Petitioner originally invested only $6,000 in the capital of the subsidiary. While it is true that the subsidiary had only one full time employee, it is also true that many services were rendered to it by part-time employees and by independent contractors. (Pet. p. 8, Pet. App. pp. 22-24.) The reason for the relatively low invested capital and the reason for maintaining only one full time employee was the decision of the Petitioner's management to start and proceed cautiously in this new venture. The Petitioner had never before operated in a foreign country either directly or through a subsidiary. That the Petitioner's decision to proceed conservatively in its approach to the operation of a foreign subsidiary was wise is well borne out by the results of its subsidiary's operations in the years succeeding the one year which was before the Courts below in which succeeding years the subsidiary operated at either an insignificant profit or at a loss. (Pet. p. 9.)

While it is true that the specific issue before the Courts below was the Petitioner's tax liability for its

fiscal year ended September 30, 1959, it is also true that the underlying issue was whether or not the rates of commission and discount which were in effect as between the Petitioner and its wholly-owned subsidiary were such as to distort the true income of the Petitioner, or to improperly shift part of its income to its wholly-owned subsidiary. While the years subsequent to the fiscal year 1959 were not before the Courts below, the Petitioner nevertheless contends that the results of the subsidiary's operations in those subsequent years (in which the rates of commission and discount remained the same) should have been considered by the Respondent and by the Courts below in their determination as to whether or not the commission and discount rates were excessive. The Respondent in his footnote on page 4 of his Memorandum contends that the figures concerning the losses in subsequent years were not substantiated, and that such losses might possibly have been caused by some imagined external factors. The results of the subsidiary's operations in these subsequent years were determined by independent Certified Public Accountants. There was no showing in the Courts below that any external factors such as political turmoil as suggested by the Respondent had any appreciable effect thereon. It seems only equitable and just that the Respondent in exercising the power conferred upon him by Section 482 of the Internal Revenue Code should take all reasonable factors into consideration. For the Respondent to make a determination on the basis of one year's operations only as he has done in this case when in fact he had the results of subsequent years' operations available to him, constitutes an unreasonable arbitrary, and abusive exercise of such power.

The Respondent argues in the footnote in his Memorandum that Petitioner's former sales representative, Baritina, was willing to continue under its old contract. The fact remains, however, that Baritina did refuse to negotiate a contract with Petitioner upon terms which were mutually acceptable. Petitioner's subsidiary was required to fulfill the functions of the former representative and in addition to assume responsibilities over and above that which had been executed by the former representative. While discharging these responsibilities it earned net income in the 1959 fiscal year, the year under consideration. However, the record in the Courts below also establishes the fact that by the use of the same commission and discount rates and while discharging the same responsibilities, subsequent years demonstrated that the subsidiary was unable to earn net income. The conclusion is inescapable that the Commissioner abused his power in fixing commission and discount rates under which the subsidiary could not function without incurring operating losses.

The Petitioner continues to contend that the fair and reasonable doctrine enunciated by the Ninth Circuit in its Opinion in *Frank v. International Canadian Corp.*, 308 F. 2d 520, was not by that Court narrowly limited to the facts before it in that case, but, on the contrary, that it was expressed therein as a fundamental principle of tax law supported by numerous Court decisions which the Court cited in support thereof. (Pet. pp. 16-17.)

For the foregoing reasons and those stated in the Petition, the Court is urged to grant the Writ of Certiorari.

Respectfully submitted,

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